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INDIAN CURRENCY FUTURES: AN ANALYTICAL STUDY OF ITS PERFORMANCE

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ABSTRACT

Since its inspection in 2008, currency derivative trade in India had experienced explosive growth, both in volumes and value over the years across all the four currencies contracts that were in operation in INRUSD, INRGBP, INREUR and INRJPY. However in terms of the open interest currency derivatives trade in MCX is more as compared to the NSE. By consider both stock and commodity exchanges for launching currency futures contracts government of India has done a commendable job which is expected to increase the number of quality players, introduce healthy competition and boost trading volumes of Indian currency futures. The global markets (mainly USA) become active only after Indian markets close at 5.00 pm and as a result there is an evident fear about the risks associated with overnight fluctuations in the currency pair. Therefore the functioning as well as the profitability in Indian currency futures is effected by the current performance of the international currency futures market. It is imperative that any evaluation, projection on Indian currency futures market should be undertaken keeping the international market in perspective.

KEYWORDS: Currency Futures, Open Interest, Contract Traded, Turnover

INTRODUCTION

Currency Futures is an agreement or contract, which involves buying or selling one currency for another (foreign exchange), on a specified future date, at an indicated price. Although foreign exchange market is quite old in India the need of exchange traded currency derivative was long awaited. In 2008 currency derivatives were allowed to be traded in the exchanges in India. On August 29, 2008 Union Finance Minister P Chidambaram launched the first Currency Futures Trading in the country at the National Stock Exchange (NSE) with the following features:

a. Only USD-INR contracts were allowed to be traded.
b. The size of each contract shall be USD 1000.
c. The contracts shall be quoted and settled in Indian Rupees.
d. The maturity of the contracts shall not exceed 12 months.
e. The settlement price shall be the Reserve Bank's Reference Rate on the last trading day.
f. Only Indian residents shall be eligible for the contracts.

Besides NSE, country's largest commodity bourse the Multi Commodity exchange of India (MCX) and Bombay Stock Exchange (BSE) has started trading the currency futures from October, 2008 respectively.

II. Contextual Background

As per the RBI guidelines residents of India are, however, granted permission to trade in currency futures or options contracts, traded on the stock exchanges which have been given recognition by the Securities and Exchange Board of India (SEBI) in India, subject to the terms and conditions mentioned by the Reserve Bank which may change from time to time. Indian Forex market got another boost when the SEBI and Reserve Bank of India permitted the trade of derivative contract at the leading stock exchanges NSE and MCX for three new currency pairs. In its recent circulars Reserve Bank of India accepting the proposal of SEBI, permitted the trade of INRGBP (Indian Rupee and Great Britain Pound), INREUR (Indian Rupee and Euro) and INRYEN (Indian Rupee and Japanese Yen). This was in addition with the existing pair of currencies that is US$ and INR. From inclusion of these three currency pairs in the Indian Forex circuit the Indian Forex scene is expected to boost even further as these are some of the most widely traded currency pairs in the world.

Apart from a small amount of brokerage fees and statutory duties and taxes traders don't have to pay commissions to the banks or foreign exchange agents in the form of spread as in the case of overseas Forex trading. If any doubt on broker regarding the trade executions traders can easily verify trade details on NSE. All the trades done on the recognized exchanges are guaranteed by the clearing corporation of National Securities Clearing Corporation Limited (NSCCL) and hence it eliminates the risks associated with counter party default.

The trading member for the proposed currency derivatives exchange will be subject to a balance-sheet net worth requirement of Rs. 1 crore, while the clearing member would be subject to a balance-sheet net worth requirement of Rs 10-crore.

The major objective of using currency derivatives is hedging the risk. Suppose if an investor in India has some business set-up in the United States and he is scheduled to receive sum of USD 10, 000 in the next 6 months. The investor is planning to utilize this return to buy further investments in India. If the value of the dollar fluctuates in another six months, there may be a loss for the investor. This is where the investor can use foreign currency hedging and utilize currency futures to minimize the risk which can occur due to foreign exchange rate fluctuation can be avoided. This avoidance of risk is known as hedging. Currency futures are an important trading tool for foreign currency hedging.

III. Review of Literature

According to the RBI-SEBI standing technical committee report (RBI-SEBI, 2008) in the context of liberalization of the capital and commodity futures market most of the participant from the both markets felt that hedging opportunity through currency trading enhance the flexibility to manage their currency risk dynamically. Even international experience shows that exchange traded currency futures contracts facilitate efficient price discovery. The launch of currency derivatives in India follows the recommendations made jointly by the Securities and Exchange Board of India and the Reserve Bank of India in May 2008.

Indian currency futures contracts would be quoted and settled in Indian rupee and the maturity of the contracts would not exceed 12 months. The futures date and price will be fixed on the purchase date. Only US dollar-Indian rupee contracts would be allowed and the contract size will be of 1,000 US dollars and the tick size (minimum price fluctuation) will be 0.25 paisa. In this regard Guru (2009) revealed that the contract size is insignificant compared with global standard like the Chicago Mercantile Exchange offers lot sizes of 12.5 million Japanese yen or Australian $100000 for a single contract. Due to small trading contract size currency futures trading not going to help existing market participants like banks but it will help small and medium size enterprises those who do not have sufficient financial strength to participate on the over-the-counter (OTC) market.

However Nath and Lingareddy (2008) pointed that with increased depth of Indian currency trading, which has reached to a daily volume of around Rs. 2000-3000 crore, despite small contract size and low daily limits for individuals and trading partners. Within a year of its inception, MCX-SX has achieved stupendous growth in average daily turnover and open interest. The average daily turnover increased from Rs. 355.66 crore during the first month of operations to Rs. 16,980 crore for the month of February 2010.

On the other hand, one should not forget that the Dubai exchange introduced a USD: INR currency futures contract in the middle of 2007 but volumes have not really picked up, belying expectation based on the fact that there is a significant commercial interest in the rupee because of exposures to the diamond and gold trade. Speaking of the ‘limited scale’, only US dollar-rupee contract (with a size of $1,000 each) is allowed now; also the trading will take place only on the platform for this exclusive purpose created by the National Stock Exchange. Choudhary (2009) revealed that uncertainties still loom large among traders and brokers as they look forward to India’s largest commodity exchange, Multi Commodity Exchange of India Limited (MCX) after SEBI gave its approval to the bourse to start Currency Futures trading. MCX as a commodity exchange falls under the regulator FMC (Forwards market Commission) whereas currency futures are regulated by SEBI (Securities and Exchange Board of India). In this regard Shah (2007) mentioned that the Government of India has not clarified as to which regulator will play an anchor role for currency derivative trading. If all the three regulators RBI the Forex market regulator, SEBI which oversees the capital market and FMC which regulates the commodity futures market – intervene without proper interaction between them, the growth of currency futures market could be seriously undermined.

Nair (2004) observed that in most of the countries, where currency futures have really flourished, the trading takes place on multiple commodity exchanges, rather than stock exchanges. Besides, since foreign operators – NRIs, FIIs etc. – are barred from participating, the new exchange means the contract can be traded only within India and that too, without involving any outflow of funds.

A study by Guru (2009) indicated that the global markets (mainly USA) become active only after Indian markets close at 5.00 pm and as a result there is an evident fear about the risks associated with overnight fluctuations in the currency pair. Once the Indian markets close, the positions cannot be reversed by the traders till the next day. The tax treatment of the gains/losses in the futures currency market would this be treated as business income as in the case of equity derivatives also not make it clear by the regulator?

IV. Quantitative Analysis

The growth of the currency futures in India has been assessed by measuring the growth in two variables which are open interest and contracts traded.

a) Open Interest

Open Interest is the total number of outstanding contracts that are held by market participants at the end of the day. It can also be defined as the total number of futures contracts or option contracts that have not yet been exercised (squared off), expired, or fulfilled by delivery. By monitoring the changes in the open interest figures at the end of each trading day, some conclusions about the day's activity can be drawn.

Increasing open interest means that new money is flowing into the marketplace. The result will be that the present trend (up, down or sideways) will continue.

Declining open interest means that the market is liquidating and implies that the prevailing price trend is coming to an end. Knowledge of open interest can prove useful toward the end of major market moves.

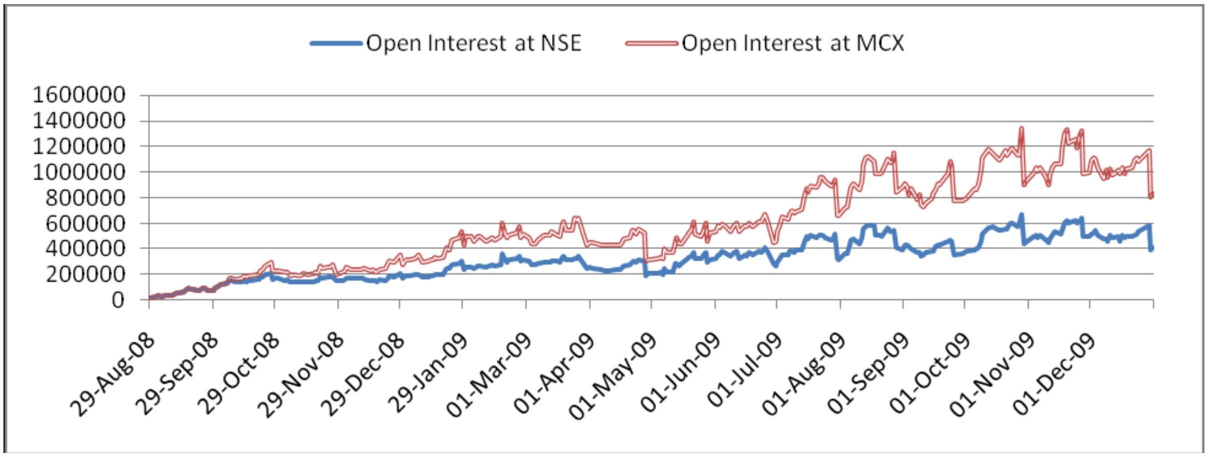
A levelling off of open interest following a sustained price advance is often an early warning of the end to an up trending or bull market.

The relationship between the prevailing price trend and open interest can be summarized by the following table.

Table-1: Relationship between price trend and open interest

Price	Open Interest	Interpretation
Rising	Rising	Market is strong
Rising	Falling	Market is weakening
Falling	Rising	Market is weak
Falling	Falling	Market is strengthening

Figure-1: Daily movement in the open interest of currency futures in NSE and MCX



Source: MCXSX website

Figure-1 shows the daily movement in the open interest of currency futures in both NSE and MCX. It depicts that the open interest in both NSE and MCX have been increasing with a steady speed since the currency futures are been traded. The open interest in the NSE was 406200 on 31st December 2009 as compared to 16332 on 28th August 2008 and that on MCX it was 425451 on 31st December 2009 as compared to 17331 on 7th October 2008. It can be seen that in terms of the open interest, the growth of the MCX is more as compared to the NSE.

b) Contract Traded

The number of contracts traded on a stock exchange shows the total volume of contracts traded. An increase in the number of contracts traded on a stock exchange expresses the growth of trade in that particular stock exchange for currency future. The number contracts traded (Table-2) in the NSE increased to 973344132 contracts on 2011-12 from 32672768 contracts on 2008-09. And as a result average daily turnover also increased from Rs.1167.43 crores in 2008-09 to Rs.19479.12 crores in 2011-12.

Table-2: Business growth in currency derivative segment

Year	Currency Futures		Currency Options		Total		Average Daily Turnover (₹ cr.)
	No. of contracts	Turnover (₹ cr.)	No. of contracts	Notional Turnover (₹ cr.)	No. of contracts	Turnover (₹ cr.)	
2011-12	701371974	3378488.92	271972158	1296500.98	973344132	4674989.91	19479.12
2010-11	712181928	3279002.13	37420147	170785.59	749602075	3449787.72	13854.57
2009-10	378606983	1782608.04	-	-	378606983	1782608.04	7427.53
2008-09	32672768	162272.43	-	-	32672768	162272.43	1167.43

Source: NSE Website

V. Conclusion

The currency futures market will have greater price transparency for the end-user. In fact, it has done a commendable job to consider both stock and commodity exchanges for launching currency futures contracts. Stock exchange will enable their large network of clients, traders, jobbers, arbitrators and speculators to trade in currency derivatives; the commodity exchange MCX will enable the hedgers, namely importers and exporters, who have genuine hedging needs for protection against bank rate fluctuation. By the introduction of exchange traded currency futures in India can now avoided the legal tangle and also bring the platform of foreign exchange in India same as developed countries. The upward trend of the open interest, number of contracts traded and average daily turnover since its inspection explain the whole story in detail. So, it can be thus concluded that the currency futures market will get more success in the coming future and the economy and the risk hedgers will definitely be benefited from this trade.

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